Franchise Financing Options

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After years of easy money for financing a franchise (or anything else for that matter), capital available for starting and growing a business shrank considerably as the U.S. and global economies began to feel the first stirrings of the subprime lending meltdown and ensuing economic recession.

While tight credit continues to slow the growth of small businesses, lending experts insist that money is out there for those with good credit, enough cash, and the patience to ride out a lengthy approval process. Just as you need a solid business plan, you also need a sound financing strategy. That strategy should include a list of several different sources of capital.

A list below summarizes many of the financing sources franchisees can explore, but first a few general guidelines to keep in mind before approaching any lender.

Start with a thorough inventory of your financial situation, listing all your assets and debts; how much you'll be able to fund and how much you'll need to borrow to survive until your cash flow turns positive; and be prepared to back up everything you say with reliable documentation. As part of your business plan, have a realistic pro forma prepared, and be ready to defend its basic assumptions.

Do all this before approaching a lender. You can start by asking your franchisor for guidance. They're eager for you to open and start generating royalties. They've already approved you, you've signed a franchise agreement, and both sides should be raring to go (pending your finding the best site if you have a retail concept).

Think like a lender. Lenders seek to minimize their risk. Help them feel comfortable not only with the dollars and cents, but with your own character, integrity, and work ethic. A lender would rather see a realistic plan asking for more money than an optimistic plan seeking less: they know one of the biggest reasons startups fail is under-capitalization.

Ask franchisees. As part of your due diligence, you met or spoke with several franchisees in the system. Did you ask the how they came up with the funds to get started? If they could recommend any lending sources or advisors? They've been down the road you're just starting on. Their experience - and contacts - can prove invaluable in procuring the funding you need.

Divide and conquer. When looking at the total amount of capital you need to borrow to get started, consider using different sources to fund portions of your total "nut." For example, separate your capital requirements into three or more parts: franchise fee, equipment, real estate, and other startup costs. Lenders specializing in equipment loans or real estate may be more willing to provide funding than a single, general source. It may be easier to find funding for real estate or equipment than for general business purposes. If you nail two out of three it may be easier to line up the remaining funding you need.

FUNDING SOURCES

Franchisors

Your franchisor is a good first stop. Ask them for recommendations. They may have agreements with lenders to not only approve a loan, but to shorten the process and help you open sooner. Some franchisors will provide debt financing themselves. Check for this in the Franchise Disclosure Document or ask directly. As credit tightened, many franchisors began to offer incentives to help franchisees get started. These included discounted or deferred franchise fees; refunded franchise fees if financing could not be procured; and even refunds and equipment buy-backs after 6 or 12 months. Ask your franchisor what they can do for you. Reducing your up-front costs will leave you more money to keep your business going and growing. Many franchisors also offer discounts to veterans, minorities, and women (see below).

Do it yourself

Cash is king, or maybe queen: As Billie Holiday wrote in 1939, "God bless the child that's got his own." Of course if you can afford the startup costs yourself, you don't need a loan - although it can make good business sense, depending on your circumstances. For years, franchisees used their home equity and 401(k) retirement funds to start their new business. That option proved less viable after the subprime crisis. Many also turned to family and friends who believed in them, but many of their finances suffered too, reducing the likelihood of finding help there.

Home equity

For those whose homes have retained their value and who own or have a significant percentage of equity in their home, this time-tested source of business start-up funding is still a good alternative. You may have to go through more paperwork than you would have a few years ago, but you still can use your home as collateral - that is, if you're willing.

Retirement funds

If you have a 401(k) or other retirement fund, you can create a C corporation that can be used to buy

You have an error in your SQL syntax; check the manual that corresponds to your MySQL server version for the right syntax to use near ') order by category' at line 1 stock in your new franchise business, thus funding it. Be aware that the IRS rules on this are under scrutiny, but companies specializing in this area have been around for years and have helped many franchisees get started.

Business partner or investor

Many new franchisees have the energy, drive, and skills to succeed, but lack the money to get started. If you're one of these, consider pairing up with a money partner, angel investor, or even a venture capitalist interested in the brand or industry you've chosen. Your franchisor can be a big help here. Many good franchisors who turn down well-capitalized applicants with no operating or industry experience are willing to pair them up with an operator they've approved who lacks the startup capital.

Conventional lenders

Large banks, the traditional bulwark of small business loans, pulled back after the subprime debacle, making loans only to those who didn't need them - no help for the many more who did. And traditional franchise industry lenders such as GE Capital and CIT pulled the plug on lending as well. In their stead, a series of alternative lenders entered the market in 2008 and 2009. Many will continue to fuel franchise expansion in years ahead. These include local and regional banks, credit unions, and … (see below).

Small Business Administration (SBA)

The SBA will guarantee a significant portion of a loan, typically up to 80 percent. Note that the SBA does not make the loan, but guarantees a large percentage of it. In theory, this reduces the risk for bank lenders, making them more willing to lend to new businesses. And it worked well for years until the subprime loans hit the fan. In early 2009, Congress passed the American Recovery and Reinvestment Act, which allowed the SBA to raise its loan guarantee to as much as 90 percent and temporarily eliminate fees on others. For the most current information, visit the SBA's website (www.sba.gov).

The Franchise Registry

Franchisors listed on the SBA's Franchise Registry offer an advantage to their franchisees seeking SBA-backed loans. Loan applications for brands listed on the Registry can be processed more quickly by the SBA and its lenders (banks) because the SBA has pre-approved their franchise agreement. Listing on the Franchise Registry adds credibility to a brand in the eyes of any knowledgeable lender.

Loan packagers or specialists

Finance companies specializing in franchise-related loans can help you in the early stages by guiding you through the lending maze. These specialists know the ropes and have connections in the lending community. These "loan packagers" will work with you from start to finish to improve your chances of success. Best of all, most get paid only if your loan comes through.

Alternative funding sources

As the large franchise lenders pulled back, new and innovative lending companies specializing in franchising, even in selected brands or industry segments or niches, appeared to fill the gap. Rates may be slightly higher, but at least they're making capital available. Many of these boutique lenders will stick around and become players.

Equipment leasing

As noted above, finding a source for funding your equipment purchase or lease will increase your chances of finding money for the rest of your new business. At the very least, it will reduce the amount you need from other lenders. Check with your franchisor to see if they have any deals with one or more equipment leasing and financing sources.

Landlords

In a good economy, landlords charge high rents and tenants pay for everything. In a down economy, the reverse is true, and you can negotiate many items before signing a lease: tenant improvement allowances, free rent, or reduced rents if a mall's anchor tenant moves out. Since you may be new to negotiating commercial leases, it's often worthwhile to hire a professional lease negotiator, consultant, or commercial real estate broker to represent you. Some franchisors have specialists on staff who can help franchisees get the best deal. And always run any lease agreement by an attorney experienced in this area. The up-front fees will pay off each month for the life of your lease.

Veterans

Many programs exist for veterans of the U.S. Armed Forces. Under the SBA's Patriot Express Pilot Loan Initiative, the SBA will guarantee up to 85 percent of the loan and requires lower credit scores for approval. These loans can be used for start-up, expansion, equipment purchases, working capital, inventory, or business-occupied real estate purchases. At the International Franchise Association (IFA), the VetFran program includes more than 300 franchisors that offer discounts and incentives to veterans on franchise fees and other startup expenses.

Minorities

The IFA also assists and encourages minority participation in franchising through the IFA Diversity Institute and MinorityFran. Many franchisors involved in these initiatives offer financial incentives to minority applicants, such as reduced or deferred franchise fees. The IFA, in collaboration with local economic development officials and national organizations, holds seminars across the country to increase the presence of minorities at all levels of franchising.

Women

Programs to encourage the participation of women in business exist at the federal, state, and local levels. And in 1996 the IFA formed the Women's Franchise Committee to encourage women to take part in franchising. The IFA's Women's Franchise Discussion Forum is an excellent source of information and networking.

State and local incentives

Some states and cities offer job-creation programs that encourage new businesses to set up shop in their area by rewarding them with economic incentives such as tax credits or loans. Check with the relevant economic development officials in your chosen territory to see if these programs exist and how to qualify.

In the end, successfully funding your franchise concept, whether in good economic times or bad, often has as much to do with who you are and how you present yourself to prospective lenders than all the number-crunching you could ever do. But run the numbers too!

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